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UNCLAS SECTION 01 OF 03 COLOMBO 002027

SIPDIS

DEPT PASS TO SA/INS, SA/RA, EB, USTR; COMMERCE FOR ARI
BENAISSA; TREASURY FOR ROY ADKINS

SENSITIVE

E.O. 12958: N/A
TAGS: ECON EFIN PGOV CE ECONOMICS
SUBJECT: Guns to Butter (and Pay Hikes, and Roads, and...):
Optimistic Budget Reopens Sri Lankan Parliament

REF: Colombo 2001

¶1. (U) This telegram is Sensitive but Unclassified, please handle accordingly.

¶2. (SBU) Summary: Finance Minister Choksy presented the 2004 GSL budget to the Parliament on November 19. The GSL sees the budget as the culmination of two years' work and a chance to relieve belt-tightening measures taken since coming to office. The budget keeps within the tight macroeconomic framework established by the government, including deficit reduction, revenue enhancement and pro-growth initiatives. Still, it included significant wage increases for the public sector, a generous voluntary retirement package and additional agricultural subsidies. Revenue collection is acknowledged as a major fiscal problem and the budget includes several measures to tackle this challenge. Most observers consider the budget fair and even opposition politicians privately admit it is a move in the right direction. The lack of any notable education initiatives is interesting, given stated GSL priorities. Defense expenditures continued to decline as a share of budget and GDP. End Summary

¶3. (U) The Finance Minister presented a budget to a somewhat raucous Parliament on November 19. Para 16 contains relevant figures and projections discussed in this cable.

Parliament Reconvenes to Hear the Budget

¶4. (SBU) Parliament had reconvened the morning of November 19, following a 15 day suspension by President Kumaratunga (Reftel). Minister Choksy, a diminutive, professorial politician, read a two-hour speech to the entire parliament, including the Prime Minister. The session was lively. Clearly suffering from a cold, Choksy took frequent breaks to blow his nose, which prompted catcalls from the opposition about whatever item he had just discussed. The GSL used the session to crow about its economic performance and complain about the President's recent political actions.

GSL Economic Achievements Touted

¶5. (U) The Minister highlighted the GSL's economic achievements including significantly improved GDP growth, debt and deficit reduction, and increased exports. FDI has also increased and the resulting foreign exchange inflows have led to a reversal of the rupee's three-year slide. Both interest rates and inflation have declined.

Expenditures to Fall

¶6. (U) On the expenditure front, the government expects a contraction of about 1% of GDP. Budget forecasts for 2004 project a historically low budget deficit (the deficit has not been lower than 7.5% since the 1977 opening of the economy). The overall deficit is to be financed by foreign grants, foreign borrowings, domestic financing and privatization receipts. Recurrent expenditures are slated to fall, leading to a reduction in the current account deficit. Capital expenditures are projected to increase. Total interest costs, which accounted for 30% of government spending in 2003, are expected to fall to about 27% in
¶2004. Spending on government corporations will also drop. Other administrative costs are expected to decline marginally. Defense will represent just under 15% of total expenditure, continuing its decline as a share of expenditure since the 2002 ceasefire. Though keeping a tight rein on spending, the GSL recognizes the need to boost the economy and upgrade infrastructure. Therefore, a key component to the new budget is.

Capital spending

¶7. (U) The GSL plans to spend $1.1 billion in 2004 on infrastructure as part of a larger 3-year development program under the PM's "Regaining Sri Lanka" development plan. Roads, power and water sectors, rehabilitation and

resettlement, and lending to small and medium industry will receive the highest allocations from the government budget. The GSL expects to spend a total $4.1 billion on capital projects from 2004-2006.

Public Sector Employee Benefits

¶8. (U) The budget provides a salary increase to government employees and pensioners. It also unveiled a costly plan to overhaul the bloated civil service. The plan aims to reduce 100,000 state jobs in 2004, and a further 200,000 by 2006 (cutting the total workforce by almost 30%). The plan calls for a voluntary retirement package, for employees over 45 years old, including an initial payment of one year's salary, full monthly salary until age 55 and then a full pension. In addition, the government has promised a debt forgiveness plan for public employees. The savings from the package will result largely from the reduction in benefits including allowances, vehicles, and housing in some instances. There could also be efficiencies gained from cutting the bloated bureaucracy (less overlap, fewer benefits and employees to monitor).

Revenue to Rise

¶9. (U) Choksy admitted a key problem in the budget is sluggish revenue. The government has tried to boost revenues and broaden the tax base, but without much success. In 2003, revenue did not meet expectations, but the GSL is projecting a nominal rise of 13 percent in 2004, a reasonable target given projected GDP growth and inflation. Choksy outlined several glaring revenue realities, including the fact that a recent tax amnesty netted 51,000 tax evaders who will now be captured in the tax net. Moreover, fewer than 3,000 of 32,000 registered companies pay taxes and only one percent of individual income earners are taxpayers. Key to improving this revenue picture will be.

Taxation

¶10. (U) Vowing to broaden the tax net, Choksy proposed a new economic service charge of 1% to be levied on all registered companies (including currently tax-free BOI companies). This tax would be deductible from the corporate tax, but would increase revenues by bringing into the tax net thousands of tax evading companies. Other key tax reforms in the 2004 budget include a unified VAT rate, reduction of the import duty surcharge and an increased income tax exemption threshold. Several other proposals aimed to increase collection from the business sector, including BOI companies. They include a tax on previously exempt foreign currency banking units and a royalty tax on new foreign companies. The GSL intends to address the weaknesses in tax administration through the establishment of a central revenue authority.

Privatization and Private Sector Development

¶11. (U) The Government will continue its privatization program. Companies listed for privatization in 2004 include State Mortgage and Investment Bank, the petroleum sector, bus companies, hotels, remaining shares of plantations and Sri Lanka Telecom. Total expected income is $154 million.

¶12. (U) The private sector will benefit from increased government spending on infrastructure. In addition, the government is to lend $361 million for small and medium industry development and to fund northeast development. Other programs will facilitate private sector activity in selected sectors. To boost tourism, the government will facilitate the development of two lagoon areas and the southern province (airport, port, coal power plant, and an oil refinery); BOI will set up two new export processing zones and the government will make land available for development within Colombo.

Comment

¶13. (SBU) The budget was well-received and got fairly glowing commentary from the IMF (which had announced that Article IV consultations would be delayed until the budget was presented), World Bank and ADB reps in Colombo. Local businesses have been enthusiastic as well. Particularly interesting was the lack of many education initiatives, which get tremendous lip service from the GSL. The decline in defense spending corresponds with optimism about the peace process.

¶14. (SBU) The GSL had leaked portions of the budget plan, specifically public sector wage increases and increased agricultural subsidies, following the President's suspension of parliament. This provided additional pressure to reconvene parliament and was used by the GSL in its litany of ways the President's actions had undermined

the economy.

¶15. (SBU) Members of the opposition used the budget hearing as a forum to voice their displeasure with the GSL and to advocate for more left-leaning social spending programs. In private though, most admit the budget is fair and well crafted, balancing the need to maintain fiscal restraint while showing the public some return after two years of austerity. End Comment.

¶16. (U) Some numbers:
20032004 (Proj)

GDP Growth5.6%6.0%
Budget Deficit(% GDP)7.8%6.8%
Debt (% GDP)100%95%
Inflation7.2%6.9%
Current Acct Deficit (% GDP)2.8%1.3%

--Forex reserves - $3 Billion (5.2 mos import cover)
--Inflation declined to 7.2% from 9.6% in 2002
--Interest rates dropped to 9.4% from about 12%
--Revenue fell in 2003 from a projected 17.1% of GDP to 16.3%. In 2004, revenue is to rise by 13.7% in nominal terms (to 16.4% of GDP).
--For 2004, total spending is estimated at $4.8 billion, or 23.2% of GDP, resulting in a budget deficit of $1.4 billion (6.8% of GDP).
--Capital expenditure will increase from $927 million (5.0%
rease from $927 million (5.0%
of GDP) to $1.1 billion (5.3% of GDP).
Deficit Finance: foreign grants ($103 million); foreign borrowings ($515 million); domestic financing ($670 million); privatization receipts ($154 million).
--Single VAT rate of 15% (replacing the current system of 10% and 20%)
--Cut in import duty surcharge to 10% from 20%.
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